Supreme Court, U.S.
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NO. _____

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1994

INVEX HOLDINGS, N.V., PETITIONER

V.

EQUITABLE LIFE INSURANCE COMPANY OF IOWA, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI
TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

Jeffrey Edward Kehl
Counsel of Record
DOWD & DOWD, LTD.
55 West Wacker Drive
Suite 1000
Chicago, IL 60601
(312) 704-4400
Counsel for the Petitioner

September 8, 1994

27 pp

QUESTIONS PRESENTED

I. Whether the interest to be awarded an oversecured creditor on its claim under §506(b) of the Bankruptcy Code should be determined by the default rate set forth in the underlying agreement between the creditor and the debtor.

II. Accepting that a default rate of interest is intended to compensate a creditor for additional fees, costs, and charges incurred as a result of a debtor's default, whether, under §506(b), an oversecured creditor is entitled to interest on its claim at the default rate set forth in the underlying agreement with the debtor when the creditor has already been awarded the actual fees, costs, and charges provided for in that agreement.

RULE 29.1 LISTING

Pursuant to Rule 29.1 of the Rules of this Court, the Petitioner, Invex Holdings, N.V., states that it has no parent company and no subsidiaries other than wholly owned subsidiaries.

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V.

EQUITABLE LIFE INSURANCE COMPANY OF IOWA, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Invex Holdings, N.V. respectfully petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., infra, 1-17) is reported at 27 F.3d 241. The opinions of the district court (App., infra, 18-42; and the bankruptcy court (App., infra, 45-69) are currently unreported.

JURISDICTION

The court of appeals entered its judgment on June 10, 1994 (App., infra, 1). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

Section 506(b) of the United States Bankruptcy Code provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be

allowed to the holder of such claim interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

11 U.S.C. §506(b).

STATEMENT OF THE CASE

This petition seeks the review of the judgment of the United States Court of Appeals for the Seventh Circuit entered on June 10, 1994 effectively denying the Objection of Invex Holdings, N.V. to the Secured Claim of Equitable Life Insurance Company of Iowa.

The jurisdiction of the court of appeals was invoked under 28 U.S.C. §158(d) upon the timely notice of appeal of the judgment entered by the United States District Court for the Northern District of Indiana which affirmed the

decision of the United States Bankruptcy Court for the Northern District of Indiana. The bankruptcy court's jurisdiction was invoked under 28 U.S.C. §157, and the district court's jurisdiction was invoked under 28 U.S.C. §158(a).

In December 1983, Terry Limited Partnership acquired the beneficial interest in the leasehold estate of commercial property in South Bend, Indiana known as the Society Bank Building. The beneficial interest was purchased from Invex Finance, B.V. for $5,700,000.00. The beneficial interest was subject to a first mortgage ultimately held by Roosevelt Savings Bank, a second mortgage ultimately held by Equitable Life Insurance Company of Iowa (hereinafter referred to as "Equitable"), a third mortgage held by

Invex Holdings, N.V. (hereinafter referred to as "Invex"), and a fourth mortgage held by Invex Finance, B.V. The third and fourth mortgages were wraparound mortgages which meant that as Terry Limited Partnership made payments toward the first and second mortgages, the balances owed on the third and fourth mortgages decreased.

The second mortgage held by Equitable secured a $2,100,000.00 promissory note and accrued contract interest at the rate of 14¼% per annum. However, upon Terry Limited Partnership's default, interest would accrue at the rate of 17¼% per annum. The third mortgage held by Invex secured a $5,171,000.00 wraparound promissory note and accrued interest at the rate of 17¼% per annum. Invex's note was subject to deferred interest which meant that Invex

would realize no gain unless Terry Limited Partnership made all payments required under superior notes and mortgages.

By April 1990, Terry Limited Partnership had fallen behind on its obligations under the respective notes and mortgages. Consequently, on April 27, 1990, Invex filed an Involuntary Chapter 11 Petition for Relief against Terry Limited Partnership. An Order for Relief under Chapter 11 was entered by the bankruptcy court on June 12, 1990. On November 22, 1991, the bankruptcy court determined that the debtor's interest in the Society Bank Building had a value of $5,350,000.00, rendering Equitable's claim oversecured, and Invex's claim undersecured.

By September 23, 1992, Terry Limited Partnership had yet to have a plan of

reorganization approved by the bankruptcy court. Accordingly, the bankruptcy court ordered the debtor's interest in the Society Bank Building sold pursuant to 11 U.S.C. §363. Prior to the sale of the property, however, Invex filed its Objection to the Secured Claim of Equitable Life Insurance Company of Iowa asserting that Equitable was not entitled to receive postpetition interest on its claim at the default rate of 17¼%.

Pursuant to the bankruptcy court's order, the debtor's interest in the Society Bank Building was sold at public auction. Invex was the successful bidder and purchased the property for $4,005,001.00. Out of these proceeds, the first mortgage held by Roosevelt Savings Bank was paid in full. Equitable was paid the outstanding principle due on its note, accrued interest at 14¼%, plus

fees and expenses incurred and itemized by Equitable. $170,800.00 of the proceeds, representing the difference between interest on Equitable's claim at the default rate of 17¼% and the base contract rate of 14¼%, were held in escrow by the debtor pending a ruling by the bankruptcy court on Invex's objection to Equitable's claim.

Prior to its ruling, the bankruptcy court heard evidence pertaining to the reasonableness of Equitable's default rate. Of particular import was the testimony of Invex's own expert witness. That testimony revealed that primarily a default rate of interest is to coerce prompt payment from a debtor. Thereafter, a default rate of interest is designed to compensate a creditor for the additional costs incurred as a result of a debtor's default. This testimony

further revealed that the 17¼% default rate agreed to by the debtor and Equitable was not unreasonable at the time of the original loan transaction. However, that rate was unreasonably high compared to prevailing market rates for similar properties at the time of the debtor's default and at the time of the Order for Relief under Chapter 11. No evidence was presented intimating that any of the fees, costs, or other charges associated with the debtor's default on the Equitable note remained unpaid. Further, no evidence was presented indicated that the 17¼% base interest rate on the undersecured, third priority Invex note was unreasonable at any time.

On March 31, 1993, the bankruptcy court entered judgment denying Invex's objection to Equitable's claim. Central to the bankruptcy court's decision was

the fact that Equitable's default rate of interest was not unreasonable at the time of the original loan transaction. The court also found that the equities of the case did not justify altering the rate agreed upon by the debtor and Equitable because, the court opined, to do so would augment the rights bargained for by Invex.

In addition, the bankruptcy court found that the default rate of interest did not overcompensate Equitable for its post-default costs. According to the court, the default rate was reasonable because it was intended to compensate for increased expenses in administering the loan and no exactitude in the amounts actually expended needed to be considered.

On appeal, the United States District Court for the Northern District

of Indiana affirmed and similarly noted that equity did not require the displacement of the default rate of interest when the interest rate's spread over and above the contract rate was within the range normally charged by lenders, and the default rate was reasonable at the time of the original transaction.

The district court further noted that the default rate did not overcompensate Equitable for its post-default administrative costs even though there was no evidence of unpaid post default expenses. According to the court, no laundry list of expenses is necessary as the agreement was bargained for by the debtor and Equitable.

On June 10, 1994, the United States Court of Appeals for the Seventh Circuit entered judgment affirming the decision

of the district court and the bankruptcy court. As with the lower courts, the appellate court found the 17¼% default rate to be reasonable in light of the prevailing market rates at the time of the original loan transaction.

The court of appeals also found that the default rate did not overcompensate Equitable. The court recognized that Equitable received appraisal fees and attorney's fees in accordance with its note. The note, however, did not compensate Equitable for "unforeseeable costs" associated with the debtor's default. Noting that there is a difference between foreseeable and unforeseeable cost of a default, the court held that the default rate was designed to protect Equitable against unforeseeable consequences of a default and did not amount to a double recovery

of the fees, costs and charges incurred by Equitable.

Invex now submits this matter for review.

REASONS FOR GRANTING WRIT OF CERTIORARI

Invex submits that this case presents an important question of federal law which has not, but should be, settled by this Court; namely, what is "interest" under §506(b) of the United States Bankruptcy Code.

In United States v. Ron Pair Enterprises, 489 U.S. 235 (1989), this Court ruled that under §506(b), interest on an oversecured claim is unqualified and that it applied to nonconsensual as well as consensual secured interests. 489 U.S. at 245-246. In so holding, this Court held that under §506(b), "interest on such claim" is not joined with "fees,

costs, or charges" and it is not modified by or related to the "provided for under the agreement" clause of that section. 489 U.S. 241-242. In short, this Court held that interest is not tied to any agreement. However, the court left unanswered, what "interest" is under §506(b).

"Interest" has been defined as the "[b]asic cost of borrowing money or borrowing on installment contract. Payments a borrower pays a lender for the use of money." Blacks Law Dictionary, 5th Ed. (West 1979). Despite such a definition, and despite this Court's ruling in Ron Pair that "interest" is distinct from "fees, costs, and charges," lower courts continue to include amounts in secured claims which do not represent the cost of money.

To a large extent, lower courts have interpreted "interest" under §506(b) as meaning the rate provided for in the underlying agreement between the debtor and creditor unless "the higher rate would produce an inequitable or unconscionable result, so as to require disallowance thereof." In re Laymon, 958 F.2d 72, 75 (5th Cir. 1992) cert. denied sub. nom. Crozier v. Bradford, _____ U.S., _____, 121 L.Ed.2d 247; In re Courtland Estates Corp., 144 B.R. 5 (Bankr. D. Mass. 1992); Matter of Gladdin, 107 B.R. 803 (Bankr. D. Ga. 1989).

Some of these courts are quite rigid in holding that §506(b) specifically means contract rate interest. Matter of Glenn, 796 F.2d 1144, 1147 (9th Cir. 1986) but see Landmark Financial Services v. Hull, 918 F.2d 1150 (4th Cir. 1990)

(interest on consensual liens awarded without contract provision). Matter of 268 LTD., 789 F.2d 674 (9th Cir. 1986).

Other courts recognize this Court's pre-Code pronouncement that "it is manifest that the touchstone of each such decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditor and the debtor." Vanston Bondholders Protection Committee v. Green, 329 U.S. 156, 165 (1946). See In re W.S. Sheppley & Co., 62 B.R. 271 (Bankr. N.D. Iowa 1986); In re D.W.S. Investments, Inc., 121 B.R. 845 (Bankr. C.D. Cal. 1990); In re Schaumburg Hotel Owner Limited Partnership, 97 B.R. 943 (Bankr. N.D. Ill. 1989). It is the latter group of courts which flexibly applies various equitable principles to

determine whether a default rate of interest is reasonable and should be applied to an oversecured claim. For example, in Sheppley, supra, the court devised a five part analysis based upon the secured creditor's risk of nonpayment, prevailing market rate, speed of reorganization, and ultimate distribution to shareholders. Others look at whether there is a justification for the enhanced default rate. In re Hollstrom, 133 B.R. 535 (Bankr. D. Colo. 1991). Still others look at whether the default rate is in keeping with current market rates. In re Laza, 69 B.R. 669 (Bankr. E.D. N.Y. 1987).

Seldom, however, is the analysis ever based upon whether the "interest" sought is actually "interest" or some other form of compensation, real or theoretical, resulting from the debtor's

default. In In re Consolidated Properties, 152 B.R. 452 (Bankr. Md. 1993), the bankruptcy court noted the distinction between what is actually "interest" and other forms of compensation:

> A default rate of interest that reflects a reasonable attempt to compensate a creditor for extra costs incurred after default is more in the nature of additional "fees, costs, or charges provided for under the agreement" than mere "interest on such claim", which is not tied to an underlying agreement by §506(b). Section 506(b) allows postpetition interest on the claims of oversecured creditors; however it does not state that oversecured creditors are automatically entitled to a bargained for rate of interest without limit. An increase in the rate of interest upon default may either be a coercive penalty or a bargained for attempt to compensate a creditor for its extra costs after default. If it is a penalty, it would inequitable to allow its impact to fall on other creditors or to allow it to destroy a debtor's opportunity to reorganize."

152 B.R. at 455.

This Court went to great lengths in Ron Pair to indicate that "interest" is not tied to "fees, costs, or charges" or to any underlying "agreement." Consolidated Properties appropriately focuses the inquiry on whether an agreed upon default rate is actually "interest." However, absent a ruling by this Court as to what constitutes "interest" under §506(b), lower courts will continue to apply analyses ranging from strict adherence to the underlying agreements between debtors and creditors to the various application of equitable principles of reasonableness and unconscionability without consistent determinations of whether the particular default rate interest is actually interest or some other cost.

The Seventh Circuit's decision in this case typifies the need for a

pronouncement that interest is interest and costs are costs. According to the court of appeals:

> Equitable's note entitled to receive appraisal fees and attorney's fees. This provision fails, however, to compensate Equitable for the unforeseeable costs associated with Terry's default. As Schefmeyer's testimony bears out, a default situation requires a creditor to actively monitor the collateral to ensure that its value is preserved. The costs incurred in performing this task very from case to case and simply cannot be provided for beforehand. Inclusion of a default rate of interest is designed to address this difficulty. [Citation omitted]. Recognizing the distinction between the foreseeable and unforeseeable costs of a default, the bankruptcy court correctly determined that the default rate was designed to compensate for losses suffered in addition to those provided for in the agreement.
>
> (App., 14).

The court of appeals viewed the default rate of interest here as being intended to compensate for "unforeseeable costs." "Interest", however, is the cost

of using money, not unforeseeable costs of default. The failure of the Seventh Circuit to make the distinction between the two blurs the demarcation between interest and costs found by this Court to exist under §506(b). The result is that Equitable has been awarded not only its actual costs incurred as a result of the debtor's default, but also undocumented, unforeseeable, and otherwise hypothesized costs labeled as "interest."

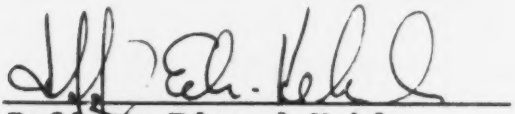
The Seventh Circuit decision is indicative of the adulteration by lower courts of the clear and unambiguous distinction between interest and costs as set forth in §506(b) of the Bankruptcy Code. Consequently, the meaning of "interest" under §506(b) has become an important federal question. This case provides the Court with the opportunity

to clarify that meaning and review should be granted for that purpose.

CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,



Jeffrey Edward Kehl
Counsel of Record
DOWD & DOWD, LTD.
55 West Wacker Drive
Suite 1000
Chicago, IL 60601
(312) 704-4400
Counsel for the Petitioner

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APPENDIX TO PETITION FOR WRIT OF CERTIORARI

Jeffrey Edward Kehl
Counsel of Record
DOWD & DOWD, LTD.
55 West Wacker Drive
Suite 1000
Chicago, IL 60601
(312) 704-4400
Counsel for the Petitioner

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JUDGMENT OF THE UNITED STATES DISTRICT COURT . . . . . [18]

JUDGMENT OF THE UNITED STATES BANKRUPTCY COURT . . . . . [45]

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 93-3371
IN THE MATTER OF:
TERRY LIMITED PARTNERSHIP,
Debtor,
APPEAL OF: INVEX HOLDINGS, N.V.

Appeals from the United States
District Court for the Northern
District of Indiana,
South Bend Division.
No. 93 C 295-**Allen Sharp**,
Chief Judge.

ARGUED FEBRUARY 14, 1994

DECIDED JUNE 10, 1994

Before CUMMINGS, BAUER, and COFFEY, Circuit Judges.

BAUER, Circuit Judge. Following the declared bankruptcy of Terry Limited Partnership ("Terry"), its chief asset, an office building, was sold at a public auction. The sale generated revenue sufficient to repay the first and second mortgage holders. Equitable Life

Insurance ("Equitable") was the second mortgage holder. According to Equitable's agreement with Terry, if Terry defaulted, interest would begin to accrue at a higher rate. At issue in this case is whether Equitable is entitled to receive this higher rate of interest for the period following Terry's default. The bankruptcy court awarded Equitable postdefault interest at the higher contract rate. Having received nothing and not liking it, Invex Holdings, holder of a third mortgage on Terry's building, contends that Equitable's postdefault interest should only have accrued at the lower predefault rate. The district court affirmed the bankruptcy court's decision. We also affirm.

I.

In December of 1983, Terry purchased the Society Bank Building, located in South Bend, Indiana, from Invex Finance. In connection with this purchase, Terry entered mortgage agreements (in order of priority) with Roosevelt Savings Bank ("Roosevelt"), Equitable, and Invex Holdings, the parent company of Invex Finance. For purposes of this discussion, only the agreements with Equitable and Invex Holdings are relevant. Terry executed a promissory note to Equitable in the amount of $2.1 million secured by a mortgage on the building. The note was payable at an interest rate of 14¼% per annum and was first due to mature on February 1, 1990. The maturity date was later extended to April 1 of the same year. In the event of default, interest was to accrue at the

rate of 17¼% per annum. Invex Holdings's note was payable at the rate of 17¼% and was scheduled to mature in December of 1987.

Terry failed to meet its obligations under either note. In a last ditch effort to survive, Terry filed a proposed reorganization plan under which a third party would loan Terry $3.3 million. Contingent on the loan and the plan being in place by September 1, 1992 and that Terry pay off its obligation to Equitable in full by October 1, 1992, Equitable agreed not to object to the proposed plan and to waive its claim to obligations accruing from December of 1991.

When Terry failed to receive the loan commitment by September 1, 1992, the court ordered that the Society Bank Building be sold at a public auction.

Invex Holdings purchased the building for $4,005,001. Roosevelt's and Equitable's claims were repaid from the proceeds of the sale. The interest on Equitable's claim, both before and after default, was calculated at the predefault rate of interest. Equitable objected, contending that interest accrued between the time of Terry's default and the sale of the property should have been calculated at the higher default rate contained in its agreement. Invex Holdings argued that if the postdefault portion was calculated at the higher default rate, Equitable would be overcompensated.

In ruling that it was reasonable for Equitable to be paid the higher default rate of interest, the bankruptcy court relied on several considerations. First and foremost, the court noted the testimony of Invex Holdings's own expert

witness, Donald Schefmeyer, who testified that it was routine for lenders to insist upon a higher default rate of interest because of the unforeseeable costs involved with collecting from debtors in default. According to Schefmeyer, a default rate of interest which exceeds the contract rate of interest by three percent was customary. Schefmeyer also conceded that in light of market conditions during the time of the transaction, the terms of Equitable's mortgage were not unreasonable. Second, the court attached significance to the fact that Invex Holding's contract rate was equivalent to Equitable's default rate. Finally, the court emphasized the importance of enforcing, as close as possible, the parties bargained-for contract rights. When Invex Holdings entered its agreement with Terry, it did

so fully aware of Roosevelt's and Equitable's superior interests in the property and the extent of those interests. In short, Invex Holdings bargained for the risky position in which it later found itself, and as the court stated, "There is nothing equitable, however, in diminishing one creditor's bargained for rights in order to augment the rights bargained for by a second creditor." The bankruptcy court ordered that Equitable be awarded postdefault interest at the higher contract rate. On appeal, the district court affirmed.

II.

We review the bankruptcy court's decision under the same standard as the district court conducts its review. The bankruptcy court's findings of fact are reversible only if that court's findings are clearly erroneous. Bankr. R. 8013.

Its conclusions of law, on the other hand, are reviewable de novo. Woodbridge Place Apts. v. Washington Square Capital, Inc., 965 F.2d 1429 (7th Cir. 1992).

Crucial to the outcome of this case is the significance of the contract default rate. Section 506 of the Bankruptcy Code provides that a holder of an oversecured claim is entitled to "interest on such claim, and any reasonable fee, costs, or charges provided for under the agreement under which such claim arose." 11 U.S.C. §506(b). The Supreme Court, in United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 (1989), held that while an award of "fees, costs, or charges" is dictated by the loan agreement, the award of interest is not. The Court did not elaborate, however, as to how the interest rate in the agreement should be

treated.

Bankruptcy courts have construed Ron Pair to require analyzing default rates based on the facts and equities specific to each case. In re Consolidated Properties Ltd. Partnership, 152 B.R. 452, 457 (Bankr. D. Md. 1993); In re DWS Invs., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990). This does not render the contracted-for default rate irrelevant. "[D]espite its equity pedigree, [bankruptcy] is a procedure for enforcing pre-bankruptcy entitlements under specified terms and conditions rather than a flight of redistributive fancy." In re Lapiana, 909 F.2d 221, 223 (7th Cir. 1990). Creditors have a right to bargained-for postpetition interest and "bankruptcy judges are not empowered to dissolve rights in the name of equity." Id. at 224. What emerges from the post-

Ron Pair decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations. In re Courtland Estates Corp., 144 B.R. 5,9 (Bankr. D. Mass. 1992); In re Hollstrom, 133 B.R. 535, 539 (Bankr. D. Colo. 1991); DWS Invs., 121 B.R. at 849 (Bankr. C.D. Cal. 1990).

Courts have found the presumption to be sufficiently rebutted in cases where the contract rate was significantly higher than the predefault rate without any justification offered for the spread. Id. For example, in Consolidated Properties, 152 B.R. 458, the court refused to award interest based on a contract default rate which was thirty-six percent higher than the predefault rate where the contract already provided that the creditor would be entitled to late fees stemming from the debtor's

default. A higher default rate of interest would have in effect enabled the creditor to recover twice for the same losses. In Hollstrom and in DWS Investments, contract default rates of thirty-six percent and twenty-five percent respectively were rejected because no evidence was presented to show that these rates were common in the market at the time of the transactions. Hollstrom, 133 B.R. at 539-40; DWS Investments, 121 B.R. at 850.

Conversely, in Courtland Estates, the creditor submitted evidence showing that the contract rate of eighteen percent was within the range of default rates charged at the relevant time. After considering the equities of the case, the court awarded the creditor postdefault interest based on the contract rate. Courtland Estates, 144

B.R. at 9.

In the proceedings below, the bankruptcy judge heard extensive testimony about the purpose of a default rate of interest. Specifically, the evidence established that a default rate is commonly included in mortgage transactions to cover the additional but unforeseeable costs and risks associated with a defaulting borrower. Further, Schefmeyer, Invex Holding's own expert witness, testified that given interest rates at the time of this transaction, a mortgage such as Equitable's with a predefault interest rate of 14¼% and a default rate of 17¼% was not unreasonable.

The record and the case law support the bankruptcy judge's conclusion that Equitable's contract default rate was reasonable. In cases where courts

refused to award interest based on the contractual default rates, it was because those rates could not be justified by demonstrated need or by prevailing industry practice. Here, Schefmeyer's testimony confirmed that default rates customarily ranged between 2½% and 4½% over the predefault rate. And while Invex Holdings's mortgage was inherently riskier than Equitable's mortgage, the fact that their own mortgage note was payable at a rate of 17¼% does undermine to some degree the claim that Equitable's default rate was patently unreasonable.

Invex Holdings contends that the decision of the bankruptcy court should be reversed because awarding Equitable the default rate of interest would provide Equitable with double recovery. Because the bankruptcy court permitted Equitable to recover the costs and

charges associated with the default as provided for in the promissory note, Invex Holdings argues that the award of default interest was inequitable.

As discussed earlier, a creditor is entitled to an award of "fees, costs, or charges," if the loan agreement provides for such an award and to the extent such an award is reasonable. 11 U.S. C. §506(b). Equitable's note entitled it to receive appraisal fees and attorneys' fees. This provision fails, however, to compensate Equitable for the unforeseeable costs associated with Terry's default. As Schefmeyer's testimony bears out, a default situation requires a creditor to actively monitor the collateral to ensure that its value is preserved. The costs incurred in performing this task vary from case to case and simply cannot be provided for

beforehand. Inclusion of a default rate of interest is designed to address this difficulty. Consolidated Properties, 152 B.R. at 457. Recognizing the distinction between the foreseeable and unforeseeable costs of a default, the bankruptcy court correctly determined that the default rate was designed to compensate for losses suffered in addition to those provided for in the agreement.

In its affirmance of the bankruptcy court, the district court noted that Invex Holdings, through Invex Finance, had realized a profit in selling the Society Bank Building to Terry. The district court observed also that in Terry's ill-fated attempt to reorganize, Equitable agreed to compromise its claim by more than $700,000. Invex Holdings contends that these two findings were clearly erroneous and that in relying

upon them in its decision, the district court committed reversible error.

We need not pass on the accuracy of these findings because they were immaterial to the district court's conclusion. After reviewing the record and assuring itself that the contract default rate was conscionable and a reasonable means of protecting against the unforeseeable consequences of a default, the district court held that Equitable should not be deprived of its bargained-for rights in order to bestow upon Invex Holdings benefits in excess of its bargain. Neither Invex Holdings's gain from the sale of the building nor Equitable's stipulation were essential to the district court's decision.

III.

By extending financing to Terry, Invex Holdings placed itself in a position subordinate to that of Roosevelt and Equitable and in doing so, knowingly took the risk that it would get nothing in the event of a default. Denying Equitable postdefault interest at the contract rate would be tantamount to transferring Invex Holdings's risk to Equitable after the fact. There is nothing equitable about such a redistribution. The decisions of the bankruptcy court and the district court awarding Equitable postdefault interest at the rate provided for in its agreement are AFFIRMED.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF INDIANA
SOUTH BEND DIVISION

INVEX HOLDINGS, N.V.,	)	
	)	
Appellant,	)	
	)	
vs.	)	3:93cv
	)	295 AS
EQUITABLE LIFE INSURANCE,	)	
	)	
Appellee.	)	

MEMORANDUM AND ORDER

A. JURISDICTION

The district court has jurisdiction to hear this appeal pursuant to 28 U.S.C. § 158 (a), which confers jurisdiction on district courts to hear appeals from final judgments, orders, and decrees of the bankruptcy court. On March 31, 1993, the bankruptcy court entered a Final Judgment and Order ("Order"), in which it resolved all issues raised by the parties to the adversary proceeding in favor of the Appellee, Equitable Life Insurance

Company of Iowa.

THEREFORE, pursuant to 28 U.S.C. § 158(a), this court has jurisdiction to hear this appeal from the bankruptcy court's judgment. Hearing and oral argument were had in South Bend, Indiana, on July 15, 1993.

B. FACTS

Invex Finance B.V. ("Invex"), filed an involuntary Chapter 11 proceeding against the debtor, Terry Limited Partnership ("Debtor"), on April 27, 1990. Debtor consented to the proceeding, and an order was entered on June 12, 1990.

Debtor purchased the Society Bank Building in South Bend, Indiana, in December 1983, from Invex Finance, granting the seller a wraparound mortgage which was subordinate to and encompassed by a first mortgage held by Roosevelt

Savings Bank ("Roosevelt"), a second mortgage held by Equitable Life Insurance Company of Iowa ("Equitable") and a wraparound mortgage held by Invex Holdings, N.V. ("Invex Holdings").[1] The court found that the value of the Society Bank Building, Debtor's major asset, was $5,350,000. Thus, both Roosevelt and Equitable had oversecured claims. Roosevelt, Equitable, and Invex are primary creditors in this proceeding. The Indiana Department of Revenue has filed a proof of claim for less than $500; Invex is the only other party to file a proof of claim.

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[1]Invex Finance is a wholly-owned subsidiary of Invex Holdings. Lake County Trust Company, acting as trustee, bought the Society Bank Building. Invex Holdings, the beneficiary of the trust, sold its interest to Invex Finance, who in turn sold its interest to Debtor. Invex Finance realized a profit of $774,000 on this resale.

Equitable's claim arises from a June 1, 1984, promissory note in the principal amount of $2,100,000, secured by a mortgage on the Society Bank Building in Equitable's favor. Debtor was to pay interest on the debt at the rate of 14 1/4% per annum. The rate of default was set at 17 1/4%. Initially, the note was payable on February 1, 1990, but then extended to April 1, 1990. The Debtor defaulted on April 1, 1990, by failing to pay the principal balance and deferred interest.

Debtor's promissory note to Invex Holdings provided for an interest rate of 17.25% per annum and matured in December 1987. Debtor's wraparound note to Invex Finance provided for interest at the rate of 17.5% per annum and also matured in December 1987. Debtor defaulted on both of these notes.

Debtor filed a proposed plan of reorganization; Invex, having submitted its own plan objected. Subsequently, Equitable and the Debtor reached an agreement ("Stipulated Agreement"), which was approved on June 10, 1992. Invex did not object to this agreement.

Under the terms of the Stipulated Agreement, if Debtor failed to comply with any one of the four conditions contained in the agreement, it would be considered in default. The agreement also provided that in the case of default, Equitable, after notifying the court, would be entitled to have the automatic stay lifted and the building abandoned from the estate, or to have the building sold under 11 U.S.C. § 363. Equitable's claim would consist of the outstanding principal balance, unpaid deferred interest accrued to the date of

maturity, and interest accruing at the default rate after maturity, plus attorney's fees and costs. Equitable agreed to waive a prepayment due under

the original terms with Debtor, thereby reducing its claim by $700,000.

Following Debtor's default, Equitable filed a motion to have the building sold. Invex filed an emergency motion to have the court modify the Stipulation Agreement to extend the Debtor's time for performance, which was denied. The building was sold pursuant to the court's order, and the auction sale totalled $4,005,001. Roosevelt's claim was paid from the proceeds. Equitable's claim was paid at the contract rate of interest. The excess proceeds of $170,800 were escrowed with the Debtor. This sum represents the

difference between interest accrued from the date of maturity to sale of the building on Equitable's outstanding balance calculated at the contract rate of 14 1/4% per annum and calculated at the default rate of 17 1/4% per annum. The Debtor makes no claim to the excess funds.

C. ISSUES PRESENTED

Invex has appealed the bankruptcy court's order, arguing that Equitable is not entitled to the default rate of interest on its claim. More specifically, Invex presents several subarguments, each of which is addressed separately by this court.

D. THE STANDARD OF REVIEW

The standard of review this court must follow when reviewing factual findings of the bankruptcy court is set forth in Bankruptcy Rule 8013 which

provides:

> On an appeal the district court or bankruptcy appellate panel may affirm, modify, or reverse a bankruptcy judge's judgment, order, or decree or remand with instructions for further proceedings. Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witness.

Fed.R.Bk.P. 8013 (1991). While findings of fact are reviewed under the "clearly erroneous" standard, the bankruptcy court's conclusions of law must be reviewed de novo. Woodbridge Place Apartments v. Washington Square Capital, 965 F.2d 1429, 1435 (7th Cir. 1992); Oneida Tribe of Indians v. State of Wisconsin, 951 F.2d 757, 760 (7th Cir. 1991); Calder v. Camp Grove State Bank, 892 F.2d 629, 631 (7th Cir. 1990).

This standard notwithstanding, the

court notes that when so-called referees in bankruptcy were first authorized they were selected directly by United States District Court Judges, often in the nature of political patronage. It is quite true that in service most of these referees developed considerable expertise in the intricacies of bankruptcy law. More than a decade ago, the system of selecting bankruptcy law judges changed radically. They are no longer selected by district judges or district courts; they are selected after an elaborate screening process by circuit judicial councils. Uniformly, a preexisting expertise in bankruptcy law is required. Each of the bankruptcy judges now serving in this district came to their task with very substantial preexisting knowledge of bankruptcy law. In this context, the standard for review of bankruptcy judges

has both a conceptual and a pragmatic aspect. It is the bankruptcy judges who see and hear the witnesses and must make basic decisions as to weight and credibility. The review process does not generally envision a trial de novo with regard to reviewable decisions by the bankruptcy court. Necessarily a bankruptcy litigant who attempts to overturn a reviewable bankruptcy decision sustains a substantial and heavy burden to demonstrate legal error. It is not for a reviewing district court to simply rewrite a bankruptcy decision on purely equitable grounds. Much of the argument that is made here is of that nature and is requesting this court to recast the bankruptcy court's decision on equitable grounds. Put simply, but not disrespectfully, there is a failure to demonstrate the necessary legal basis for

this court to disturb the decision of the bankruptcy judge. This court is not in any way here compelled to do so and therefore respectfully denies that request.

E. DISCUSSION

Invex argues that Equitable is not entitled to a default rate of 17 1/4%. The appellant claims that the bankruptcy court erred on four distinct issues, each of which this court will address separately. The parties do not dispute that Equitable is entitled to receive interest. As an oversecured creditor, Equitable is entitled to interest under 11 U.S.C. § 506(b):

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges

provided for under the agreement under which such claim arose.

The parties here are disputing whether the default rate of interest should apply to Equitable's claim. The bankruptcy order reflects that the parties agree that courts consider the equities of the case before applying or denying a default rate; thus, no rigid analysis applies here:

> Equitable states "(C)ourts applying Code section 506 consistently and uniformly hold that an oversecured creditor is entitled to claim and receive interest at the higher default rate specified in the agreement from which the claim arose unless the equities dictate application of the lesser contract rate." [Equitable's memorandum filed January 20, 1993, at 7.]

> Invex states "(A) bankruptcy court has the equitable power to modify a contract provision that calls for the assessment of a higher interest on the oversecured creditor's claim when the award of the higher rate would adversely impact the distribution of a bankruptcy estate's assets to other creditors." [Invex's memorandum filed January 21, 1993, at 5.]

In the Matter of Terry Limited Partnership, Case No. 90-30864 (Order) at 6-7. The bankruptcy court outlines its standard of analysis:

> When deciding whether equity requires that a contractual default rate should not be utilized, there is no hard and fast rule or standard test to apply which governs the decision. In each case the court must look to all of the circumstances existing in that particular case. Matter of Laymon, 958 F.2d 72 (5th Cir. 1992); In re Hollstrom, 133 B.R. 535, 539 (Bankr. D. Colo 1991) (acknowledging that under certain circumstances equity warrants deviating from the contractual default interest rate, but nothing that "there is no clear, emerging, definite enumeration of these special circumstances or equitable considerations").

(Order at 7-8).

However, Invex, while acknowledging and even arguing that a broad equity analysis applies in this case, has asserted that the bankruptcy court has erred based on specific elements of analysis. First, Invex claims the

reasonableness of a default rate is to be determined by whether it is reasonable at the time of default, not at the time the loan was made. Thus, asserts Invex, "[b]y turning its attention to the date of the original loan transaction, instead of the current market, the bankruptcy court misapplied the law, and as such, should be reversed. (Appellant's Brief at 11). Invex itself, however, correctly states that "[s]ince the adoption of the Bankruptcy Code and the Ron Pair decision, lower courts have followed the pre-Code rule of determine post-petition interest on the basis of the equities of the case, again recognizing that bankruptcy necessarily alters the contractual rights of all parties (Appellant's Brief at 9). In this case, the bankruptcy court's order does address the reasonableness of the default rate at

the time the loan was made, but that is only one prong of its analysis of "the equities of the case." The bankruptcy court also looked at the "customary range" of the current lending market, and Invex's own witness testified that "default rates are generally 2 1/2 to 4 1/2 percent over the contract rate" (Order at 8). This court concludes that the bankruptcy court did not err in considering all factors of the default rate. See Matter of Laymon, 958 F.2d 72 (5th Cir. 1992).

Invex next argues that the evidence established that Equitable's default rate was excessive at the time of default, and that the bankruptcy judge erred by finding the rate reasonable:

> Had it properly looked at the current rates of interest obtainable for a mortgage such as Equitable's,

> the bankruptcy court would have been faced with the uncontradicted evidence that in the secondary market, 17 1/4% is simply excessive and unreasonable. (TR pp. 17-18). To be sure, Donald Schefmeyer, the only expert witness to testify, stated that a reasonable contract rate for a mortgage holding Equitable's position would be 9 3/4% to 10% and that a reasonable default rate would be 12 3/4% to 13%.

(Appellant's Brief at 11). This argument is ironic as well as brazen, given that Equitable's default rate equals Invex's contract rate and is lower than Invex Finance's contract rate (all promissory notes having been issued approximately six months of each other). In essence, Invex argues that this court must find that Equitable's default rate is excessive, so Invex can recover on the same percentage rate for its contract rate. This court agrees with Equitable and Judge Rodibaugh that the critical factor of the analysis is the

reasonableness of the differential between default rates and non-default rates. The testimony of Invex's expert regarding the differential, as well as the cited case law, support Judge Rodibaugh's conclusion that the default rate was not excessive. In re Schaumberg Hotel Owner LTD. Partnership, 97 B.R. 943, 951 (Bankr. N.D. Ill. 89); In re White, 88 B.R. 494, 498 (Bankr. D. Mass 1988); In re Skyler Ridge, 80 B.R. 494, 498 (Bankr. C.D. Cal 1987).

Invex argues alternatively that, since Equitable faced no realistic risk of nonpayment of the full amount of its claim, the bankruptcy judge erred in finding the default rate reasonable. Both in the bankruptcy court and here on appeal, the appellant bases its argument on In re W.S. Sheppley & Co., 62 B.R. 271 (Bankr. N.D. Iowa 1986). Invex argues

that here, as in Sheppley:

> Equitable had a substantial equity cushion to be exhausted before it ever faced the risk of nonpayment. Accordingly, the award of default rate interest by the bankruptcy court gave Equitable a windfall profit for being second in line, all to the detriment of other creditors, including Invex. On that basis, the bankruptcy court erred and should be reversed.

(Appellant's Brief at 12-13). This court agrees with the bankruptcy court that Sheppley does not stand for the proposition that unless a party can show that it faced a risk of nonpayment, it cannot recover at the default rate. Again, as the bankruptcy court stated: "When deciding whether equity requires that a contractual default rate should not be utilized, there is no hard and fast rule or standard test to apply which governs the decision. (Order at 8). The parties do not dispute that a reasonable default rate should only be denied in

order to assist other creditors who would otherwise be affected. Invex has advanced that this court should not grant the default rate so as to benefit other creditors. However, this court notes that the only creditor who would benefit from such an equitable ruling is Invex. In balancing the equities in this case, it is important to consider that Invex was aware of Equitable's interest at the time it entered into an agreement with Debtor. Also again, this court is being asked to deny Equitable's default rate so that Invex can recover on its junior claim at the same rate. This court agrees with the bankruptcy court's position:

> The court may diminish one creditor's bargained for rights in order to protect a second creditor's bargained for rights. There is nothing equitable, however, in diminishing one creditor's bargained for rights in order to augment the

> rights bargained for by a second creditor.

(Order at 11). This court finds that equity does not demand that this court deny this bargained for right.

Invex argues that the bankruptcy's finding that the default rate of interest did not overcompensate Equitable for post-petition matters was clearly erroneous. Invex argues that without evidence that Equitable needed the default rate to cover costs, fees and charges that had not been paid, "the bankruptcy court could only find that the award of default rate interest would overcompensate Equitable" (Appellant's Brief at 13). Judge Rodibaugh analyzed the default rate as to its purpose:

> The standard practice of charging a higher interest rate after default is designed as an incentive to the debtor to make timely payments. However, its second purpose is to compensate the lender for any loss

> resulting from the default such as increased expenses administering the loan and delayed use of the money. The lender's loss on any given defaulted loan will rarely be exactly the additional amount received by charging interest at the default rate. Sometimes the loss will be greater, and sometimes less. A lender cannot know at the time it extends a loan the exact amount of loss it will suffer in the event of a default. Instead, the lender relies on a default interest rate which it has determined is a reasonable approximation of its potential loss. When the differential between the contract and default rates is not excessive and falls within the usual and customary range, it is legitimately related to the purpose for which it was designed and should not be construed as a burdensome or unconscionable penalty. E.g., In re Schaumberg Hotel Owner LTD. Partnership, 97 B.R. 943, 951 (Bankr. N.D. Ill. 1989); In re White, 88 B.R. 494, 498 (Bankr. D. Mass. 1988); In re Skyler Ridge, 80 B.R. 500, 511 (Bankr. C.D. Cal. 1987).

(Order at 9). This court does not agree with Invex that a court could not find a default rate reasonable unless the claimant could present a laundry list of

expenses. The terms of the loan agreement between Debtor and Equitable were bargained for, as were the terms between Debtor and Invex, who would assert that its own rate in excess of 17% is reasonable as agreed to by the parties. This court does not find that Equitable has been overcompensated by the conclusions reached by Judge Rodibaugh; as the order stands, Equitable has compromised its claim by $700,000.

Invex has also argued that it cannot be bound by the terms of the Stipulated Agreement, as it was not a party to this agreement. Invex claims that the bankruptcy court judge erred in considering the agreement in its determination that the default rate was reasonable. As both the bankruptcy court and this Judge have noted, this appeal rests on equity principles. The

bankruptcy judge considered the Stipulated Agreement in light of his equitable balancing, and found Invex's conduct less than persuasive. He noted that Invex neither objected to this agreement, nor did it avail itself of its opportunities for appeal. The terms of the Stipulated Agreement provide that Equitable would compromise its claim and not object to Debtor's proposed plan of reorganization if financing were obtained within a specified time frame. The parties agreed that should Debtor fail to meet this time frame, Equitable would be entitled to its full claim, and that the interest rate would be calculated at the default rate. Invex has argued that it the bankruptcy judge erred, "granting greater rights into the Stipulation than actually existed..." (Appellant's Reply Brief at 9). Invex argues that it cannot

be bound by the Stipulated Agreement because it is not a party, but its actions constitute a recognition of the agreement. Instead of objecting to the Stipulated Agreement or the court's approval at the appropriate time, Invex attempted to alter the terms to extend Debtor's time for compliance. In essence, Equitable is now bound by terms that grant it less than the original agreement, despite Invex's argument that it is granted more. Since equitable principles govern here, this court is hard pressed to find any basis for denying Equitable its bargained for rights so that Invex can undo its former failure to act. Invex's argument has separated each issue claiming each is reversible error. This court takes the position that all issues were considered in the totality of the circumstances, and

the bankruptcy order does not stand and fall as a whole based on the enforceability of the Stipulated Agreement. This court also, in considering each of the factors in light of the whole, does not find the bankruptcy judge's consideration of this agreement reversible order. Absent unconscionability or punitive nature of the terms, the terms agreed to between Debtor and Equitable, as the holder of the senior lien, should not be set aside. Invex was aware of the percentage rates of Equitable's loan at the time it formed its own agreement with Debtor. Invex cannot now argue that its junior lien should prevail over Equitable's senior claim. As Judge Rodibaugh pointed out, the Stipulated Agreement constitutes Equitable's second bargain for its default rate (Order at 12). At the time

of the formation of this agreement, Invex could have objected, allowing Equitable to withdraw from less favorable terms. Even these circumstances would not have vitiated Equitable's original claim; as the facts stand now, Invex has failed to show that it is entitled to equitable relief, nor has it shown that the Stipulated Agreement changed its situation from the one Invex bargained for its right in. Further, this court notes that Invex Finance realized a profit of $774,000 on the resale of the Society Building, a fact which further undermines any argument of inequity in this case.

F. CONCLUSION

Based upon this court's reasoning and the statutes and cases cited, the Bankruptcy Court's decision is **AFFIRMED.**

IT IS SO ORDERED.

DATED: August 24, 1993.

Chief Judge
United States District Court

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
SOUTH BEND DIVISION

IN THE MATTER OF	)	
	)	
TERRY LIMITED	)	CASE NO.
PARTNERSHIP	)	90-30864-RKR
	)	
Debtor	)	CHAPTER 11

APPEARANCES:

Jeffrey E. Kehl, Esq., and Edward Benchik, Esq., 224 West Jefferson Blvd., Suite 511, South Bend, Indiana, 46601, attorneys for Invex Holdings, N.V. and Invex Finance, B.V.;

Michael B. Watkins, Esq., Barnes & Thornburg, 600 1st Source Bank Center, 100 North Michigan Street, South Bend, Indiana, 46601, attorney for Equitable Life Insurance Company of Iowa;

Alex Edgar, Esq., Assistant United States Trustee, Suite 555, One Michigan Square, 100 East Wayne Street, South Bend, Indiana, 46601;

William A. Thorne, Esq., Thorne, Grodnik, Ransel, Duncan, Byron & Hostetler, 228 West High Street, Elkhart, Indiana, 46516-3176, attorney for Debtor.

DECISION and ORDER

At South Bend, Indiana, on March 31, 1993.

This matter is before the court on the OBJECTION TO CLAIM OF EQUITABLE LIFE INSURANCE COMPANY OF IOWA, which was filed by Invex Holdings, N.V. and Invex Finance, B.V. (referred to jointly as "Invex") on October 6, 1992. Equitable Life Insurance Company of Iowa filed its response on October 15, 1992. A hearing was held on December 21, 1992. Both parties subsequently filed briefs, and the matter was taken under advisement on February 22, 1993. Invex objects to the claim of Equitable Life Insurance Company of Iowa to the extent that such claim is for post-petition interest calculated at the contractual default rate.

Jurisdiction

This decision shall represent findings of fact and conclusions of law pursuant to Federal Rule of Civil Procedure 52, made applicable in this proceeding by Federal Rules of Bankruptcy Procedure 7052 and 9014. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2), over which the court has jurisdiction pursuant to 28 U.S.C. § 157(b)(1).

Background

Invex Finance initiated this bankruptcy proceeding by filing an involuntary Chapter 11 petition against Terry Limited Partnership ("Debtor" herein) on April 27, 1990. Debtor consented to the proceeding, and an Order for Relief was entered on June 12, 1990.

In December 1983, Debtor purchased the Society Bank Building, located in

South Bend, Indiana, from Invex Finance, granting Invex Finance a wraparound mortgage which was subordinate to and encompassed a first mortgage on the building held by Roosevelt Savings Bank ("Roosevelt"), a second mortgage held by Equitable Life Insurance Company of Iowa ("Equitable"), and a wraparound mortgage held by Invex Holdings, N.V.[2] The Society Bank Building was Debtor's major asset.[3] By order dated November 22, 1991, the court found the value of the

[2]Invex Finance is a wholly owned subsidiary of Invex Holdings, N.V. The Society Bank Building had been sold to Lake County Trust Company as trustee under a trust agreement. Invex Holdings, N.V. was the beneficiary of the trust. Invex Holdings, N.V. sold its interest in the building to Invex Finance. On the same day Invex Finance proceeded to sell its newly purchased interest in the building to Debtor. Invex Finance realized a profit of $774,000 on this resale.

[3]As a practical matter this was a single asset case.

building to be $5,350,000. Both Roosevelt and Equitable had oversecured claims.

Roosevelt, Equitable, and Invex are the primary creditors in this bankruptcy proceeding. Only Invex and the Indiana Department of Revenue have filed proofs of claim. The Indiana Department of Revenue's claims is less than $500. Equitable's claim arises from a June 1, 1984 promissory note in the principal amount of $2,100,000 executed by the Debtor in Equitable's favor, and secured by a mortgage on the Society Bank Building.[4] Under the terms of the promissory note Debtor was to pay interest on the debt at the rate of 14 1/4% per annum, and in the event of

[4]The promissory note restates a prior loan made to the Debtor by Cohen Financial Corporation which was subsequently assigned to Equitable.

default at the rate of 17 1/4% per annum.[5] The note was originally payable on February 1, 1990, but, at the request of the Debtor, extended to April 1, 1990. The Debtor defaulted on the note by failing to pay the principal balance and deferred interest by April 1, 1990.

Debtor's promissory note to Invex Holdings called for interest at the rate of 17.25% per annum, and matured in December 1987. Debtor's wraparound note to Invex Finance provided for interest at the rate of 17.5% per annum, and also matured in December 1987. The Debtor defaulted on both notes.

After Invex filed its involuntary petition against Debtor, Debtor filed a

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[5]The promissory note also called for Debtor to make monthly payments in an amount less than the accruing interest. A the time the note matured, Debtor was to pay the principal amount and the accrued but unpaid interest.

proposed plan of reorganization which was predicated upon obtaining a loan from some third party in an amount not less than $3,330,000. Debtor was negotiating for a loan commitment with ITT. Invex Finance, which had submitted its own proposed plan of reorganization, filed its objection to Debtor's plan. Equitable and the Debtor then reached an agreement which was approved by the court on June 10, 1992 ("Stipulated Agreement"), and which was not objected to by Invex.

Under the Stipulated Agreement, Equitable promised to compromise the amount of its claim as well as the rate of interest accruing from December 1, 1991. Equitable additionally agreed not to object to Debtor's plan of reorganization. Equitable's agreement with Debtor was conditioned upon Debtor

(1) making adequate protection payments when due, (2) obtaining the necessary loan commitment by September 1, 1992, (3) receiving a final, nonappealable order of confirmation by September 1, 1992, and finally, (4) payment in full to Equitable by October 1, 1992. Debtor would be considered in default if it failed to comply with any one of the four conditions. The parties further agreed that if Debtor should default, after notice to the court, Equitable would be entitled to have the automatic stay lifted and the Society Bank Building abandoned from the estate, or to have the building sold pursuant to 11 U.S.C. §363. In addition, Equitable's claim would consist of the outstanding principal balance, the unpaid deferred interest which had accrued to the date of maturity, interest accruing at the

default rate after maturity, and attorney's fees and costs.

On September 1, 1992, Debtor had neither obtained the requisite loan commitment nor received an order of confirmation. As a result of Debtor's default, the court ordered the Society Bank Building sold at public auction to the highest bidder. At the auction held on December 21, 1992, the building was sold to Invex Holdings for $4,005,001. Roosevelt's claim was paid from the proceeds of the sale. Equitable's claim, calculated at the contract rate of interest, was also paid. Excess proceeds in the amount of $170,800 were segregated and deposited with the Debtor. This amount represents the difference between interest accrued from the date of maturity to the date of sale on Equitable's outstanding balance

calculated at the contract rate of 14 1/4% per annum and calculated at the default rate of 17 1/4% per annum.[6] The Debtor makes no claim to these funds. Invex argues that Equitable's claim should be calculated at the contract rate of 14 1/4%, since applying the default rate would be inequitable to Invex and other inferior creditors.[7]

Discussion

There is no dispute that Equitable is an oversecured creditor entitled to interest under § 506(b) which states:

> To the extent that an allowed secured claim is secured by property

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[6]The amount owed to Equitable as of December 15, 1992, calculated at the default rate was $3,153,194.81. Calculated at the contract rate the amount owing was $2,982,394.81.

[7]Invex originally contended that Equitable's claim should be calculated at the federal judgment rate, but now agrees that Equitable should receive the contract rate of 14 1/4%.

> the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

11 U.S.C. § 506(b) (Callaghan 1992-93). The parties also agree that generally courts do not rigidly apply or deny the default rate, but make the determination after considering the equities of the case.[8] The court, having reviewed the

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[8]Equitable states "(C)ourts applying Code section 506 consistently and uniformly hold that an oversecured creditor is entitled to claim and receive interest at the higher default rate specified in the agreement from which the claim arose unless the equities dictate application of the lesser contract rate." [Equitable's memorandum filed January 20, 1993, at 7.]

Invex states "(A) bankruptcy court has the equitable power to modify a contract provision that calls for the assessment of a higher interest rate on the oversecured creditor's claim when the award of the higher rate would adversely impact the distribution of a bankruptcy

case law, agrees with this position.[9] and, after analyzing the equities in the present case, concludes that Equitable is

entitled to receive interest at the default rate of 17 1/4%.

Invex cites In re Sheppley & Co., 62B.R. 271 (Bankr. N.D. Iowa 1986) to support its opinion that "courts have devised an equitable two part analysis when deciding which interest rate should apply." [Invex's memorandum at 6.] Invex argues that under the Sheppley test

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estate's assets to other creditors." [Invex's memorandum filed January 21, 1993, at 5.]

[9]The Supreme Court has stated that "(i)t is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditor and debtor." Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 157 (1946).

the court should determine the risk of nonpayment which the oversecured creditor faced, and determine the interest rates prevailing in the relevant market during the pendency of the bankruptcy. However, the court does not agree that Sheppley has set forth a blanket "test" to be applied in all cases. Rather, the Sheppley court simply considered the above to be pertinent factors in that particular case. Id. at 278. In fact, the Sheppley court described five, rather than only two, factors which it considered germane to its determination.

When deciding whether equity requires that a contractual default rate should not be utilized, there is no hard and fast rule or standard test to apply

which governs the decision.[10] In each case the court must look to all of the circumstances existing in that particular case. See Matter of Laymon, 958 F.2d 72 (5th Cir. 1992); In re Hollstrom, 133 B.R. 535, 539 (Bankr. D. Colo. 1991) (acknowledging that under certain circumstances equity warrants deviating from the contractual default interest rate, but neither "that there is no clear, emerging, definite enumeration of these special circumstances or equitable considerations"). While the court took Sheppley into account, it did not

[10]A creditor's right to receive interest at either the contract or default rate may be altered in bankruptcy. However, the right itself is created by state law. Butner v. United States, 440 U.S. 48 (1979). Thus, before the bankruptcy court proceeds with its equity analysis, the creditor must have a right to the subject interest rate enforceable under state law. There is no dispute that Equitable has such a right.

consider the Sheppley factors conclusive in the present case.

The 17 1/4% interest rate is not unreasonable, and, at the time Debtor obtained the loan, was well within the range of rates being charged by other lending institutions. Mr. Schefmeyer, who testified on behalf of Invex, reported that default interest rates are commonly found in loan documents, and that the default rate is often expressed as a percentage increase over the contract rate. Mr. Schefmeyer further testified that default rates are generally 2 1/2 to 4 1/2 percent over the contract rate. Equitable's default rate is 3% greater than its contract rate, and so falls well within the customary range described by Mr. Schefmeyer. The standard practice of charging a higher interest rate after default is designed

as an incentive to the debtor to make timely payments. However, its second purpose is to compensate the lender for any loss resulting from the default such as increased expenses administering the loan and delayed use of the money. The lender's loss on any given defaulted loan will rarely be exactly the additional amount received by charging interest at the default rate. Sometimes the loss will be greater, and sometimes less. A lender cannot know at the time it extends a loan the exact amount of loss it will suffer in the event of a default. Instead, the lender relies on a default interest rate which it has determined is a reasonable approximation of its potential loss. When the differential between the contract and default rates is not excessive and falls within the usual and customary range, it is legitimately

related to the purpose for which it was designed and should not be construed as a burdensome or unconscionable penalty. E.g., In re Schaumberg Hotel Owner LTD. Partnership, 97 B.R. 943, 951 (Bankr. N.D. Ill. 1989); In re White, 88 B.R. 494, 498 (Bankr. D. Mass. 1988); In re Skyler Ridge, 80 B.R. 500, 511 (Bankr. C.D. Cal. 1987). Cf. Matter of Timberline Property Development, Inc., 136 B.R. 382 (Bankr. D.N.J. 1992) (finding that a 3% increase upon default was unenforceable under New Jersey state law as a penalty where the lender testified that the higher rate was designed to coerce prompt payment). Invex would have the court deprive Equitable of interest payments calculated at a reasonable default rate of 17 1/4% in order that Invex might realize more on its own claim calculated at its regular

contract rate of 17.25% (Invex Holdings) /17.5% (Invex Finance). The court is satisfied that equity does not require such a result.

"The only good reason for refusing to give a creditor in reorganization all that he bargained for when he extended credit is to help other creditors, the debtor's assets being insufficient to pay all creditors in full." Matter of Chicago, Milwaukee, St. Paul and Pacific Railroad Company, 791 F.2d 524, 527 (7th Cir. 1986). No creditors other than Invex will be affected by awarding Equitable its default rate. This is not a situation where numerous creditors, who have unexpectedly found themselves in a low priority unsecured position, are facing a minimal payment, or no payment at all. Invex knew at the time it entered into its transaction with the

Debtor that its collateral was already encumbered by two senior liens. It most likely also knew the extent of Debtor's obligation to the senior creditors, including the rate of interest being charged by each of them. In an arms length transaction Invex bargained for its third place position. The evidence does not suggest that the value of the Society Bank Building plummeted dramatically subsequent to Invex extending its loan to Debtor, and therefore, Invex has always been only a partially secured creditor.[11] Outside the bankruptcy context, had Equitable

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[11]Debtor's wraparound promissory note in favor if Invex Holdings was in the principal amount of $5,171,000. However, since it was negatively amortized, the balance owing at maturity was $6,161,304. The original principal amount of Debtor's wraparound promissory note to Invex Finance was $5,945,000. This note was also negatively amortized so that the amount owing at maturity was $7,043,376.

foreclosed immediately after the Debtor defaulted, Roosevelt and Equitable would have been paid in full before Invex received any payment. The bankruptcy proceeding has not changed the relative position of the parties. The court may diminish one creditor's bargained for rights in order to protect a second creditor's bargained for rights. There is nothing equitable, however, in diminishing one creditor's bargained for rights in order to augment the rights bargained for by a second creditor.

The court has also considered the effect of the Stipulated Agreement on the present dispute. Under the Stipulated Agreement Equitable promised to compromise its claim and refrain from objecting to Debtor's proposed plan of reorganization on the condition that Debtor obtained financing and a confirmed

plan within certain time limits. In consideration for Equitable's promise, the Debtor agreed that if it could not meet the time limitations, Equitable would be entitled to its full claim, including interest at the default rate. This Stipulated Agreement was approved by the court and became binding on the parties. Invex neither objected to the Stipulated Agreement, nor appealed the court's order approving the Stipulated Agreement. Equitable originally bargained for a 17 1/4% default interest rate. Invex, knowing that there was a senior lien on the Society Bank Building and that the lienholder was entitled to interest at the default rate of 17 1/4% per annum, nevertheless granted Debtor a loan and accepted its position as junior lienholder on the building. Equitable bargained a second time for the 17 1/4%

default rate, and Invex failed to object. Had Invex objected, and had the court found that Equitable could not claim the 17 1/4% interest, the terms of the Stipulated Agreement would have been altered. Equitable would have had the opportunity to withdraw from the agreement as altered. The court is not inclined to now revise the rights and obligations created by the Stipulated Agreement, approved by the court, and depended upon by Equitable.

Accordingly, the court will deny Invex's objection to Equitable's claim, and authorize the Debtor to release to Equitable the excess sale proceeds of $170,800 which Debtor has been holding pending resolution of this dispute. It is SO ORDERED.

Robert K. Rodibaugh, Judge
United States Bankruptcy Court